Microsoft Planning Meeting
Puerto Rico Manufacturing Project
Tuesday, March 29, 2005
9AM

Attendees: Greg George, Brian Burt, Brett Weaver, Anne Welsh, Dick Boykin, David Unger

MS wants to implement a ramp-up strategy, where it produces some products today, but Brett and Greg are pushing for the move of all intangibles to PR immediately. PR doesn't produce the CDs but they would manage the process.

Objective of Friday meeting: obtain agreement on plan for immediate implementation
For meeting: Timed agenda needed. Meeting Thursday evening for discussion of comments.

Goals of Friday meeting:
- Planning for structure of Microsoft Meeting;
- Key segments, tasks, milestones and deliverables for project;
- Follow on to meeting points from the Autumn;
- Identify issues that need to be addressed
- Business Continuity planning.

Anne: for work plan, add in data requests and data analysis for the work plan

Brett: how hard would it be to expand the data request to add on the points from the previous work.

Brian: Estimated timeline needed for Friday meeting.

Dick: How good are they at producing the data you need? Answer: not good. Timeline will be dependent upon our reception of timely financial data.

Preliminary results needed for implementation on July 1, and further, final results will be submitted at a later date.

Brett: Could this cause problems in giving them an estimate at the end of the year?

Anne: Final number not available at July 1.

Brett: What is the risk of having different number?

Dick: truing up the number at the end of the year may leave them with a very different number.

Government Exhibit
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MS has some comfort in entering into the cost-sharing agreement June 1, with a start date of July 1.

John Peterson of Baker will be at meeting and he is interested in the start date and validity of the cost-sharing agreement. Peterson concerned about Sales being used as allocation driver of cost sharing agreement.

Brett: In buy-in payment, based on intercompany sales price, or 3rd party sales price. If we use intercompany, we use residual profit split and does this become so 'circuitous' that we lose validity?

MS wants to use all the same cost sharing pools on all agreements, and in this one, we need to separate out marketing costs.

Anne: If it is book R&D, can we not classify it as R&D?

Brett: 'Clearly no.' Amounts differ by multiple millions of dollars. Different categories of R&D. There is a significant marketing component in R&D cost centers. The company has looked at these people and given them a title of 'marketing'. They will have to dig into the cost pool and weed out the marketing costs.

Nancy – run the numbers both ways and the differences are negligible. If you break it out vs. Use the same pool, you come up with the same answer.

See Brett's structure for plan of implementation and append to document. Purchasing the CDs for $1, selling the finished CDs to corp. for $120. Sub-part F income, but this is loss. For all the intangibles you are trying to buy into, do it on July 1. Economically lose one year if you wait past July 1. The economics look as though they start a year later.

From first day, they are getting the benefit.

Staggered start means that some intangibles are depreciated from day 1, and some depreciated later, the tracking is a much more complicated measure. How do you define the 'right' itself. MS enters into the agreement with these contingencies, as production capacity increases.

Brett: They propose to buy into what they make. This may change from month to month.

Anne: in order to calculate, you need to know what they will make.

Brian: segmented P&L needed to decide what is being made over time.

Anne: For the purpose of the meeting, we can discuss this on the immediate implementation stream, and then the economic implementation stream will follow.

Brett: Detailed discussion needed, but we can't brush off these issues and try to discuss them later. John Peterson will have a huge impact on what they do. We need to identify the difficult issues, then if we can reach consensus, these are the decision makers and we need to move forward.

Start with a run-through of what will be accomplished and why it would be beneficial, structure flows, targeted benefits: 30 minutes.

Global tax models and package of information need to be sent to Dick for review on his way out. Built in assumptions.

Effective date of the implementation - effectively connected income - exclusive rights: could complicate staggered implementation. CFC acquires rights on non-exclusive basis. New technology would be owned by CFC on an exclusive basis. 18 month ramp up, but after 6months, if they had newly developed technology, they would have to be compensated appropriately and economically.

936 benefit in buy-in through fiscal 06. They can start with cost share but still get the 936 benefit.

Preliminary fact analysis, put down the facts the way we see them. Understanding the level of manufacturing activity. Anti-piracy is something that CFC could easily be involved in. Input on R&D as relates to manufacturing, and some element of the R&D process takes into account how they must take into account the need for anti-piracy. Important to understand how it is currently being accomplished with its vendors.

Brett: Notes from initial meetings could be shared (!)

Wish list for things that need to be discussed on Friday? Financial data are in the proper format and that we receive data on confirmed dates. Very short time to do a lot of work, and we need to put pressure on them to supply the data in a timely manner. P&Ls are domestic rather than international. Product level P&Ls that are needed do not exist. MS was able to create them for OEMs, so they are able to pull the information if they know how to write the proper queries.

Limit the product breakdown that we need. How many products will be involved. Four products categories before: Windows Desktop, Windows Server, MS Office, and everything else. Ended up creating a single royalty rate for all products, calculating each one separately and then summing it up at the bottom. We can assume the same product breakdown and then do a similar breakdown this time.
Will Longhorn have a longer life, and a longer lag, than previous releases? Longhorn will be the largest project and largest profit driver for several years to come.

Item 2 on fact gathering, draft statement of facts. Proforma flows, invoicing, POs, etc. This raises process questions. CFC making CDs, vendors need cushion stock (appx 20% of order), and full product will now be shipped via 'packaged product' channel. No

cushion stock that Corp could not account for. We think it's a different issue when it comes to select and enterprise CDs. You really don't know what the price will be for the select CD, and are different from CDs produced for FPP. (One CD can produce 1 million revenue.) CFC cannot hold inventory in the US. When that CD goes to third party vendor to put in Select Box, it needs to transfer to Vendor. Should PR be entitled to 55% of revenue? How do we judge that when it leaves PR?

Brett: we should sell it for $1, with the view that that initial payment is sufficient to transfer title, with more payment to follow dependent upon how much they eventually earn. Could these later payments be characterized as royalties? If so, you have PFP income on the dollar, and the royalties are taxed. So we rely on the idea that if you don't acquire copyright RIGHTS but only copyright materials, then they have no right to duplicate outside the company, not present the software, but it is not copyrights. Must pass title, but can't know the real value until after it passes. We don't want to charge the $1 but it must have real transfer in order to create the value transfer. What rights were transferred to the customer?

Master site licenses (select licenses or site licenses) are sold to large customers, but the ultimate number of licenses isn't known until later.

Retail marketing is broad. OEM marketing is small and focused. Retail marketing is broader and based on creating demand in the market place. Direct marketing level is very different from FPP and OEM marketing. On select and enterprise channel, the decision maker is one corporate/chief technology officer versus end user.
Sub-Part F tax issues consensus deliverable. Finalize rep letter and create advocacy piece (note Peterson may step in and wish to represent MS in this regard). Functional analysis must also be done for this Subpart F rule.

Business Continuity planning must be done here, as some products will be made in Mexico, and discuss what part the ramp-up will mean for more contract manufacturing. Robust part of discussion on Friday.

Entity reorg and structuring issues: must be in place before agreement is signed. PR incorporated company. How do we move rights into new CFC? Timing of wind-up of MS Puerto Rico. Could be sister or subsid of MS PR.

Brett: Are there any PR issues that would impact the cash that needs to stay in PR?

Greg: No, but to be confirmed.

Structure in the cost sharing arrangement itself. Unique attribute is that there is only one customer and that's it's related party parent.

Economically, there is no impact on who gets paid one piece.

Exec summary of economic analysis needed as deliverable. Used last time for discussion with IRS if life/lag/depreciation assumptions are questioned. If there is consensus on economics, also used for building consensus discussion with Mike Boyle and other executive for discussions and understanding.

Deliverable: draft number on the buy-in. Financial statement impact. Whatever we do on the buy-in it should not throw CFC into a loss.

Anne: From a timing standpoint, we calculate royalty rate for the project period, if there are changes in the buy-in or IP over the period, do we go back to the beginning of the agreement or do we just adjust going forward?

Brett: should be just going forward.

Anne: missing piece is the financial data we need to use, cut by product? Separate out enterprise and select? We need to get agreement on that before we can review the draft buy-in analysis. Economic consensus should define this prior to work.

Main goal for this meeting: Create scope of work, assign responsibility for scope of work, create eng letter with fee estimate. EY bought the work last time, and there may be fee sensitivity there. But this work needs to be very detailed and incredibly great documentation to refute any IRS issues. They understand investment costs (in the billions), a couple million in fees will not be as big a problem.

What's the most reliable basis for beginning the cost-share? We don't need to give them a template for computing the cost share, but maybe we need to ask that question. For the buy in we need to determine what the intangible development costs are because we capitalize those.

Do we need to do anything in educating their auditors in 404 tax provision? Final GAAP Accounting in work plan, but we need to add in 404.

To do: Discuss life and lag on previous projects – Call David Guenther

Driving down pricing results on analysis

What is needed from a tax planning perspective, but with respect to FPP, if we use profit split, we need to develop an intercompany price on disks.

Do 3rd parties have true-ups? Do 3rd parties have commensurate with income? Even though you are imbedding the intangible in the disk.

We don't want to have something that looks like a royalty if we can avoid it. I would not consider a CWI make-up payment as non-starter for subpart F. There are CWI agreements that adjust the royalty payments that determine the price of intercompany transfer of products. You are subject to CWI because of the imbedded intangible.

Do we have any examples of how you implement a CWI provision with imbedded intangibles?

Exit strategy? In their prior deals, there were contingencies that retroactively nullified the agreement. IF the government developed a cap, the agreement would be null and void. These exit strategies will most likely be discussed at the meeting on Friday.

What unique provisions need to be discussed?

Distribution agreements, service agreements, etc. all need to be discussed.

Whether we use this paper as a discussion as a guide, or we use a timeline as a straw man, it would be useful. A timeline puts more emphasis on the scope of work. Do we take this document here or do we start with Anne's?

Needed: issues discussion list and more specific detail on the task list.

Copy of the economics piece to Paul, and the non-economic side, Brett will created refined copy of issues.

MS Project who's who

David Guenther – Microsoft in-house economist
Glen Cogswell? – Director, project manager from MS
Nancy Perks – Director, Brian and Anne's primary contact
Tracy Neighbors – Owner of the project, but Glen is PR manager
Tom Sullivan – provided financial data in last engagement
Susan McGregor.